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October 4, 1996

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**OCT - 4 1996**

Federal Communications Commission  
Office of Secretary

**EX PARTE**

William F. Caton  
Acting Secretary  
Federal Communications Commission  
Mail Stop 1170  
1919 M Street, N.W., Room 222  
Washington, D.C. 20554

Dear Mr. Caton:

Re: CC Docket No. 96-45

Yesterday, John Gueldner, Vice President-Regulatory, Pacific Bell, and I met with Commissioner and Joint Board member Julia Johnson in Tallahassee, FL to discuss the matters set forth in the attached document. Please associate this material with the above referenced proceeding.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,



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# Universal Service & Interconnection

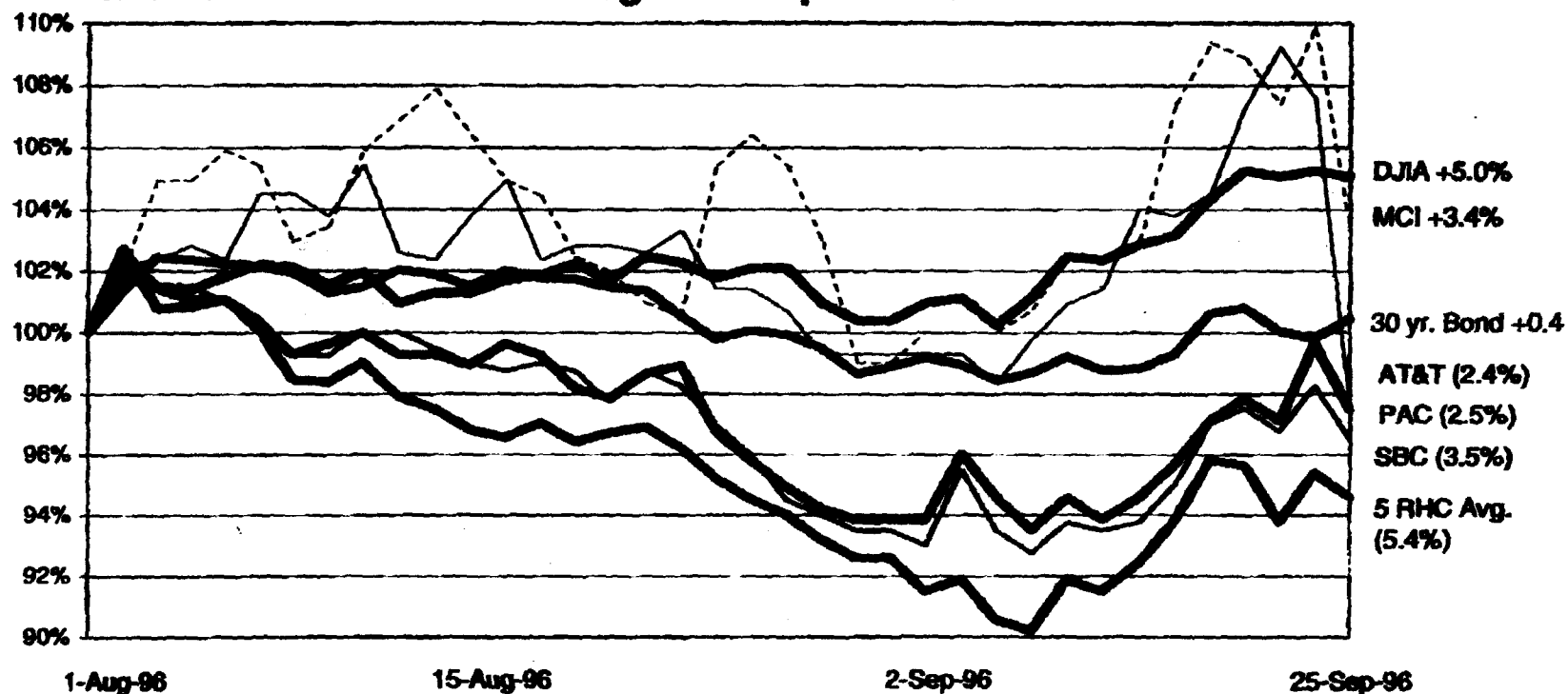
Joint Board Presentation  
October 1996

# Primary Concerns with the FCC Order

- **Order gives tremendous advantages to CLCs**
  - Very low proxy and resale prices-not cost based, violates state jurisdiction
  - Rebundling permits IXC's to avoid Joint Marketing Restrictions and Resale Prices
  - Adequate Universal Service Funding Plan is not linked to opening local market
- **Order is unreasonably unfavorable to Pacific Bell**
  - FCC has expanded forms and uses of Unbundled Elements:
    - Operating Support Systems defined as Unbundled Elements
    - Rebundling of Unbundled Elements to create Virtual Resale
  - Pacific Bell faces huge development challenge to deliver on these new requirements
- **Order does not define a smooth transition to a competitive market**
  - Places pressure on States to increase residence basic service prices
  - Most Favored Nations Requirement destroys true negotiations
  - Assumes that Pacific Bell will continue to be dominant facilities provider
  - Demotivates investment in local networks and new technologies and support of Universal Service

# Impact of FCC Interconnection Order

**Relative Price Performance - August 1 - September 25**



- Although the long distance stocks responded favorably immediately following the FCC's press release on interconnection, the negative impact on the RHCs began following the release of the full order on August 8<sup>th</sup>.
- The RHCs began to gain back ground following the announcement on Sept. 6<sup>th</sup> that four RHCs would appeal the FCC order. The strong performance may also be attributable to an easing of concerns related to an interest rate increase.
- Between August 1<sup>st</sup> and September 25<sup>th</sup>, the RHCs lost 5.4% and AT&T lost 2.4%, compared to gains of 5% on the Dow and 3.4% on MCI.

# **96-98 Creates Significant Profit Opportunity for CLECs**

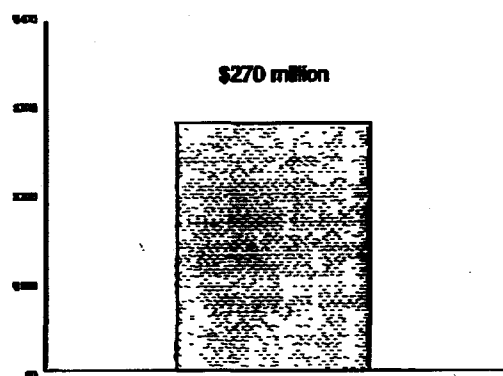
Three alternatives are created for CLECs to profitably serve:

- High revenue customers (9%):
  - Buy unbundled links & use own switch
- Mid-range revenue customers (46%)
  - Buy unbundled links & BOC's switch
- Low revenue customers (45%):
  - Serve via BOC's resale services

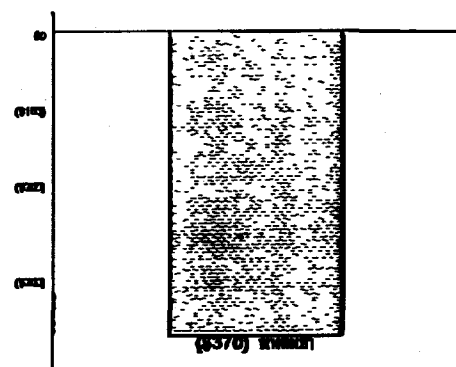
## **The Interconnection Order Enables IECs to INCREASE Profits while Dramatically Reducing Pacific Bell's Profits**

**Pacific will implement Prices and Terms which meet the FCC Order Requirements even though Pacific has filed an Appeal of that Order.**

**Estimated AT&T Pre-Tax Annual Margin  
from Residence Local Services in Calif. with 98-98 Order**



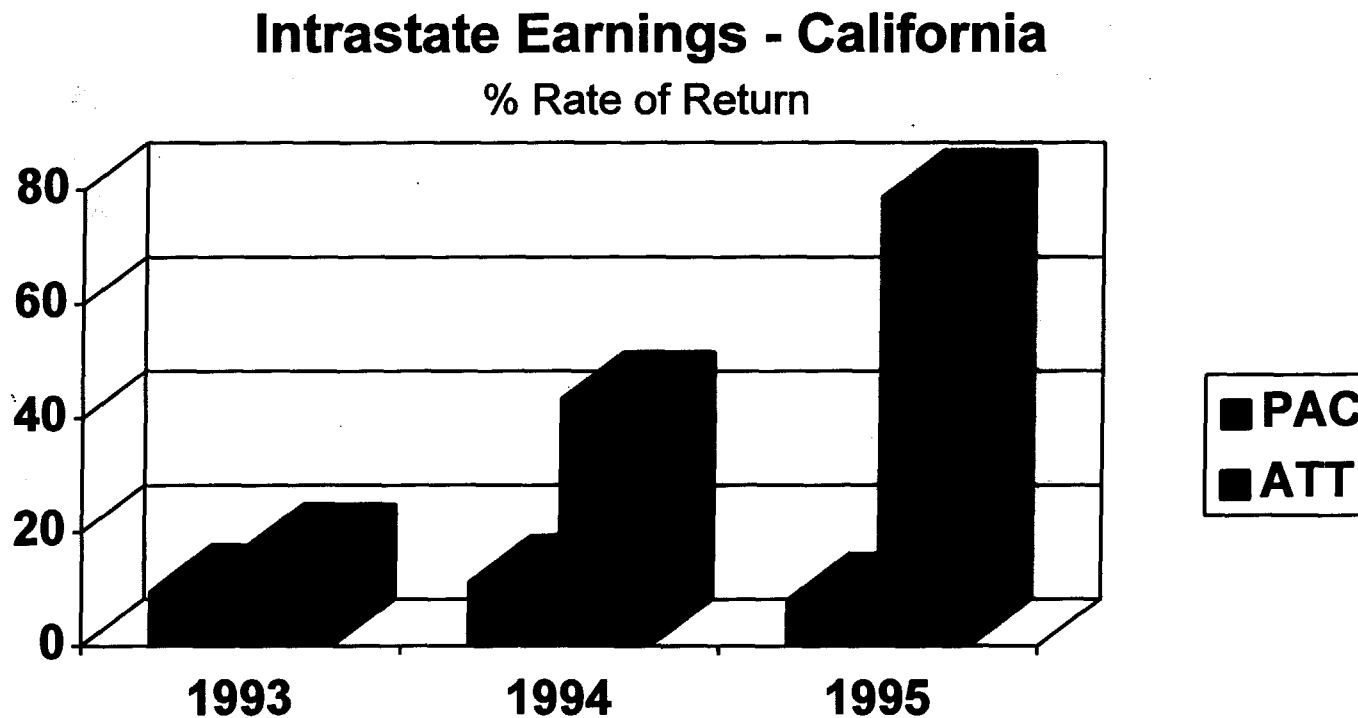
**Pacific Bell Annual Loss of Pre-Tax Earnings  
due to Local Competition in Residence Market Only**



**AT&T's proposed prices are used for this illustration.  
Annual estimates by end of 1998 w/o switched access restructure impact.**

**The FCC Order dramatically reduces incentives for Network Investment  
by Pacific and Other LECs and CLECs.**

# IXCs Do Not Need Financial Help From Regulators



- Pacific's reductions in switched access prices have dramatically increased AT&T's earnings.

# Subsidy & Interconnection

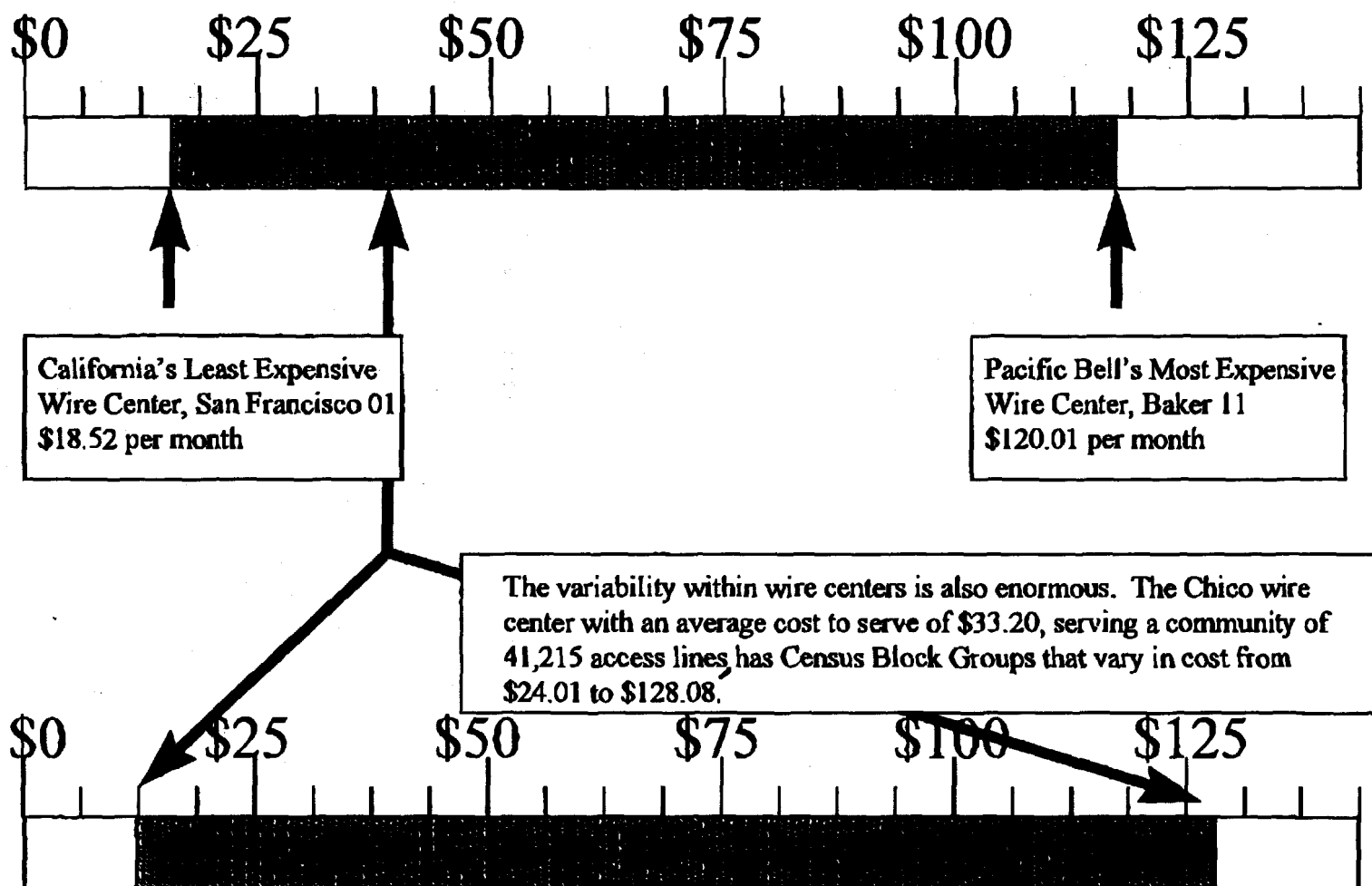
- Subsidy dollars must flow to party incurring the cost but not recovering it
- For unbundled element purchasers, subsidy can be apportioned between purchaser and incumbent
  - Can be based on percentage allocation:
    - Link facilities provider gets 95% of subsidy
    - Remainder to switch facilities provider
  - Can be apportioned through appropriate model:
    - Model output will include cost per CBG, as well as segregated costs for link, switch, usage etc.
    - Party providing facilities receives subsidy for that element
- For resale, subsidy must go to facilities provider unless costs are fully recovered through wholesale price



# The Subsidy Must Be Appropriately Targeted

- A new Universal Service fund, accurately sized, could make today's implicit subsidies explicit. Act requires a “specific, predictable and sufficient” mechanism to fund subsidy
- Current system targets study area (state). Penalizes carriers who serve states with mix of high cost and low cost areas
- Subsidy dollars must be narrowly targeted to prevent cream-skimming. Target subsidy calculation to census block groups or grid cell

**There is Extreme Variation in the Cost of Basic Exchange Service which  
Must be Recognized in any Universal Service Solution**



# COMPARISON OF USTA COSTOUTS OF UNIVERSAL SERVICE FUND DISTRIBUTION

AFFORDABILITY BENCHMARK	FEDERAL FUNDING (\$000,000)	STATE FUNDING (\$000,000)	TOTAL UNIVERSAL SERVICE FUND REQMTS (\$000,000)
1% federal median income	595.5	1473.5	2069.0
0.7% state median income	1026.2	1042.8	2069.0
1.0% state median income	492.2	1576.8	2069.0
0.7% county median income	1087.2	1081.8	2069.0
1% county median income	567.8	1501.2	2069.0
1% county median income with 1 sd cap on floor & ceiling	582.4	1486.6	2069.0
1% county median income with 1.5 sd cap on floor & ceiling	572.5	1496.5	2069.0
1% county median income with 2 sd cap on floor & ceiling	568.0	1501.0	2069.0

# A Benchmark Price

- FCC must set just, reasonable and affordable rates
- Affordability must be targeted so low income customers are not penalized for living in affluent state
- A national or statewide benchmark obscures the wide variation in rates and income levels
- Target benchmark to county income level
- A county median income benchmark (0.7%) addresses the income disparities between urban and rural
- Low income households in all communities will continue to benefit from the Lifeline program

# Universal Service - Jurisdictional Issues

- Congress intended universal service provisions to yield “just, reasonable and affordable” rates
- There should be one Universal Service Fund for the nation. Jurisdictional split based upon benchmark not separations rules
- Benchmark approach complies with Act.
  - FCC funds costs above benchmark
  - Congress allows states to adopt rules for “additional definitions and standards to preserve and advance universal service to the extent that it is not inconsistent with federal rules”
- FCC’s Interconnection & Pricing rules apply to both interstate and intrastate matters
- Additional subsidy received should be trued-up by using both state and federal rates:
  - Universal Service definition is for state local services so offset additional funding by reductions in state (toll) prices
  - Offset federal CCL

# Education Proposal

- Distribute funds directly to schools & libraries via credits. Providers redeem credits for cash from the fund.
- Allocate funds according to:
  - Threshold for all institutions
  - Incremental support based upon number of students
  - High cost, low income, technological impoverishment variables
- Carry annual allocations over year-to-year so institutions who are not ready do not lose support

## **Actions for Universal Service Joint Board**

- Establish a fund large enough to address the impact of Interconnection decision
- Establish reasonable benchmark. Target benchmark to relatively small area (county).
- Determine costs above benchmark using either actual costs or accurate proxy model
- Distribute subsidy based on small geographic unit (census block group at the minimum) to avoid cream-skimming